

ON-FILE NSC RELEASE INSTRUCTIONS APPLY

MINUTES  
ECONOMIC POLICY COUNCIL

November 7, 1985  
1:00 p.m.  
Roosevelt Room

Attendees: Messrs. Baker, Block, Pierce, Miller, Darman, Whitfield, Burnley, Sprinkel, McAllister, Daniels, Johnson, Driggs, Danzansky, Khedouri, Hoffman, Ortner, Stucky, and Wallis, and Ms. Eickhoff, and Ms. Risque.

1. Economic Review

Mr. Johnson, Assistant Secretary of the Treasury, stated that the economy currently is growing at a faster pace than earlier in the year. He also suggested that there is a data lag, particularly with regard to imports, that may lead to our underestimating real growth. He noted that the current period compares well with past expansions and suggested that the economy is now entering a second phase of expansion, with increases in inventory investment and net exports. Other signs of accelerating growth include increasing employment, new orders, and purchases of capital goods. He suggested that housing starts are also likely to increase at a faster pace in the near term. He pointed out that the inflation rate has remained moderate, with the recent increase in wages reflecting increased productivity. Mr. Johnson also noted that the so-called risk premium, measured as the spread between AAA and BAA bonds, is narrowing and the stock market is reaching new highs.

Mr. Johnson stated that the national income GNP accounts will be rebased later this year, probably resulting in a larger estimate of real economic growth over the period 1972-84.

Ms. Eickhoff, Associate Director of the Office of Management and Budget, stated that fourth quarter growth will probably be quite strong. She explained that the good agricultural harvest could add as much as \$7 to \$10 billion to national output, or as much as two percentage points to real GNP growth. She suggested also that the introduction of a new IBM computer could also provide a substantial boost to growth. She stressed that the major impetus for further growth will be inventory accumulation. Ms. Eickhoff then briefly reviewed the dynamics of inventory accumulation and depletion.

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Dr. Sprinkel stated that money growth has grown very rapidly this year, raising concerns about future inflation. He pointed out that historically monetary velocity has been fairly predictable, causing a reliable relationship between M1 and inflation. He noted, however, that velocity has not increased since 1982, which is unusual. He suggested several reasons for the aberrant behavior of velocity: (1) volatile money growth over the past four years has lead to volatile velocity; (2) financial institution deregulation has created new investment and savings instruments, which blur the lines between transactions accounts and savings accounts; (3) a decline in interest rates has made it less "costly" to hold money; and (4) a significant decline in inflationary expectations.

Dr. Sprinkel stated that the economy apparently can now absorb greater M1 growth, without generating inflation under the current circumstances. He cautioned, however, that in his opinion 13 percent growth in M1 is excessive, even with velocity growth of zero, and he suggested that the Federal Reserve should immediately begin to gradually reduce money growth. He observed that although there is no current evidence of reacceleration of inflation, the lag between money growth and inflation is roughly eighteen to twenty-four months.

The Council discussed whether a gradual reduction in M1 growth would affect real GNP growth in the fourth quarter. Dr. Sprinkel suggested it would not have an effect because of the lag between money growth and economy activity. Mr. Miller questioned the predictability of the lags in the relationships between M1-inflation and M1-real GNP. Mr. Johnson noted that relationship between M1 growth has been declining since August, and that the monetary base has not experienced acceleration similar to M1.

The Council also discussed the recent behavior of interest rates. Secretary Block suggested that short-term rates should not as high as they are, given the current relatively low inflation rate.

Dr. Sprinkel explained that, historically, the long-term real interest rate has been roughly 3 percent, while the short-term real rate has been 1 percent. He noted that it is difficult to properly estimate real interest rates because real rates are the difference between the nominal rates and inflationary expectations, not the current inflation rate. Ms. Eickhoff noted that the Gramm-Rudman Amendment could have some effect on long term expectations leading to lower real interest rates.

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The Council also briefly discussed possible future Federal Reserve's policy. Ms. Eickhoff noted that Federal Reserve Chairman Volcker has indicated that the Federal Reserve will not change policy. Dr. Sprinkel suggested that Chairman Volcker's statement might be interpreted as meaning that the Federal Reserve will not aggressively restrain M1 growth.

The Council also discussed the likelihood of a continued expansion. Dr. Sprinkel noted that the length of expansions are not preordained, but are the result of proper government policies. Mr. Wallis stated that the Administration has broken the pattern of inflation, which bodes well for a continued expansion. The Council strongly endorsed the importance of reducing the Federal budget deficit.